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In The

Supreme Court of the United States

October Term, 1988

EDWARD C. ABELL, JR. AND CAREY WALTON, INDIVIDUALLY AND AS REPRESENTATIVES OF THE CLASS OF PURCHASERS OF WESTSIDE HABILITATION CENTER REVENUE BONDS,

Petitioners,

versus

WRIGHT, LINDSEY & JENNINGS, VALLEY FORGE INSURANCE COMPANY AND JOE E. FRYAR,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

REPLY BRIEF OF PETITIONERS

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1. WLJ Misrepresents Its Role.

WLJ argues that its involvement was limited to "simply review[ing] the offering documents in summary, preliminary and final form for the underwriters". WLJ misrepresents its fundamental role. Rather than merely reviewing documents in final form, WLJ performed the indispensable functions of (1) ensuring that the offering documents adequately disclosed the material facts; (2) performing the due diligence investigation requiring underwriter's counsel to independently investigate the facts; and (3) drafting, revising, and approving the offering documents.[1] (T.v.81, 5, 12, 21; T.v.83, 48-49). WLJ admitted that according to their time records it *prepared* the initial draft of the Summary Memorandum.[2] (T.v.81, 109-112). Although WLJ now suggests it made only a few revisions to the offering documents, Menz admitted to making critical revisions to the offering documents, including deleting references to Fryar's ownership in the Cheneyville property and Fryar's obligations to purchase the Bonds. (T.v.81, 114-115; T.v.82, 8-10).

WLJ's attempt to minimize the critical role of underwriters' counsel simply ignores the realities of the transaction and the custom and practice of the securities industry in which the obligations of underwriters' counsel include having the primary working responsibility for ensuring the adequacy of disclosure in the offering documents and proper performance of the due diligence investigation. (T.v.84, 52). Contrary to WLJ's argument that the role of underwriters' counsel is severely limited, underwriters' counsel *controls* the disclosure in the offering documents. (T.v. 83, 54). WLJ nevertheless suggests

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[1] The trial court expressly found that WLJ "*prepared* and revised offering documents". (Pet., A-107-108).

[2] The Summary Memorandum was used to induce investors to invest. (T.v.81, 109; T.v.62, 21).

that bond counsel which issued an opinion letter addressed to WLJ's clients, the underwriters, is the party responsible for adequacy of disclosure. WLJ neglects to state that the letter merely opines as to the validity of the bond issuance, the trust indenture, and mortgage and is not concerned with the adequacy of disclosure. Bond counsel's role is the more limited one, and does not include responsibility for adequacy of disclosure or due diligence. (T.v.83, 122).

WLJ also misrepresents the parties' expectations, arguing that "nothing in the offering documents indicate that WLJ in any way approved the adequacy of the offering documents' disclosure". (WLJ, 1). However, the inclusion of WLJ's name on the offering documents connotes approval of the document.[3] In short, try as it might, WLJ cannot refute the fact that it assumed the indispensable role of underwriters' counsel, was responsible for disclosure and prepared, revised and reviewed offering documents with the expectation that investors would rely upon its actions.

2. The Artificial Benchmark Urged By WLJ For Holding Attorneys Liable Is Unwarranted And Illogical.

Attorneys engaged by underwriters to ensure full disclosure to the investing public, which is expected to rely upon the disclosures, owe a duty of disclosure to investors. WLJ apparently does not contend that attorneys never owe a duty to disclose. Rather, WLJ argues that the duty is imposed only upon attorneys signing offering documents or rendering opinions, regardless of the attorneys' involvement and role in the securities offering. Creation of this artificial benchmark is unwarranted and illogical.

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[3] The Ninth Circuit agrees that mere inclusion of a professional's name on the offering document is tantamount to a stamp of approval. *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653 (9th Cir. 1988).

WLJ has cited no authority holding that lawyers who prepare and review offering documents for potential investors with the expectation that the investors will rely upon their actions owe no duty to the public.[4] Instead, WLJ suggests without explanation that the courts of appeals' decisions cited by petitioners, none of which rest their decision upon the existence of an opinion letter, are consistent with the court of appeals' decision in this case.

WLJ's attempts to distinguish the cited court of appeals' decisions are unpersuasive.[5] WLJ tries to minimize the directly conflicting holding of the Tenth Circuit in *Cronin v. Midwestern Oklahoma Development Authority*, 619 F.2d 856, 862 (10th Cir. 1980) that bond counsel which participated in the issuance of bonds "owed a duty to all of the buyers to reveal the facts", arguing the decision merely reversed a summary judgment. The procedural posture of that decision, however, does not necessarily diminish its precedential value. Indeed, the seminal case of *Shores v. Sklar* heavily relied upon by WLJ and the court below similarly merely reversed a summary judgment. Further, the Tenth Circuit in *Cronin* expressly considered the issue of whether, as a matter of law, plaintiffs were required to prove that the lawyers were privy to the fraud perpetuated by the salesman. The Tenth Circuit rejected the proposition, holding that participation in the bond issuance is sufficient. *Id.* at 862. Contrary to WLJ's suggestions, the Tenth Circuit's decision did not rest upon the existence of the lawyers' opinion letter

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[4] WLJ cites *Dirks* and *Chiarella*. These cases are inapposite. They do not involve attorneys. They also considered a duty to speak as opposed to this case involving a duty to act to correct statements. (Pet., A-115, n.22).

[5] WLJ's attempts to distinguish the numerous district court decisions cited by relying upon the artificial opinion letter distinction. However these cases, like the court of appeals' decisions, did not rest their holdings on such an artificial distinction. Moreover, WLJ makes no effort to distinguish the other cited cases.

concerning the legality and tax status of the bonds, topics far afield from the omitted facts concerning the value of the bonds. *Cronin* squarely conflicts with the decision here.

WLJ argues that *S.E.C. v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972) does not conflict because the duty was imposed solely as a result of the attorney having dealt with the purchasers. The court makes no such statement, instead suggesting that the attorney's duty arises from his expertise and knowledge that the federal securities laws required disclosure. WLJ also contends that *Manor* did not find a duty to investors because it was an SEC action. The duty element of a § 10b action is not altered because the SEC is the plaintiff. Subsequently, in *Freschi v. Grand Coal Venture*, 767 F.2d 1041, 1049 (2d Cir. 1985), the Second Circuit held liable under § 10b three lawyers and their law firm which prepared the offering documents, although only one lawyer dealt directly with purchasers. Privity is not required in the Second Circuit. Nor are opinion letters.

WLJ incorrectly suggests that the decision below does not conflict with Ninth Circuit decisions because the Ninth Circuit has limited the scope of an attorney's duty to the attorney's clients, relying upon the fact that the case cited by petitioners' involved a suit by clients against their attorney. WLJ is wrong. In *DCD Programs, Ltd. v. Leighton*, 833 F.2d 183, 190 (9th Cir. 1987), the Ninth Circuit recognized that a duty to disclose may arise from a fiduciary relationship, knowledge of insider information, *or* knowing participation in a fraudulent scheme. More recently in *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653 (9th Cir. 1988),[6] the Ninth Circuit held that an accounting firm's knowledge of the alleged violation and consent to use of its name in offering memoranda may be sufficient to create a duty of disclosure to investors under § 10(b). These cases establish that the

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[6] Although *Roberts* involved an accounting firm rather than attorneys, that fact was not critical to the court's opinion.

Ninth Circuit neither limits the attorney's duty to clients nor requires an opinion letter for imposition of the duty.[7] The Fifth Circuit's decision in this case hinging liability simply on the basis of existence of an opinion letter conflicts with these decisions.

Moreover, the artificial benchmark urged by WLJ is illogical. Conspicuously absent from WLJ's brief is any argument justifying imposing liability on attorneys in a public securities offering based upon the artificial benchmark of execution of a document, while ignoring their own expectations of investor's reliance. This glaring omission is understandable because the artificial benchmark simply is illogical and leads to absurd results. Such a rule would permit securities professionals retained to ensure the adequacy of disclosure to avoid liability simply by not signing the offering documents they author while imposing liability upon unqualified lawyers not charged with the disclosure obligation because they rendered opinions upon completely unrelated topics such as the validity of a mortgage. The Court should resolve this important unsettled question of federal securities law to avoid such absurd results.

3. The Affiliated Ute Presumption.

WJL argues that the decision below did not establish a rule of law but merely made a factual finding that the case primarily involved misrepresentations. WLJ's argument misses the point. Any determination of whether a case involves primarily omissions or misrepresentations

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[7] WLJ argues that its admission regarding expectations of reliance by investors are irrelevant. To the contrary, as established by *Roberts*, the Ninth Circuit, among others, considers the reasonable foreseeability of reliance upon the parties' actions to be critical. *See also Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1011 (11th Cir. 1983), see Pet.10, n.14. Considering foreseeability here, WLJ's testimony not only is relevant, but squarely establishes its expectations of reliance, which justifies imposition of the duty to disclose.

is made by consideration of controlling legal principles. WLJ's argument ignores the legal principles applied by the court below in its determination, which principles conflict with the cited decisions. The principles applied below provide that the *Ute* presumption is inapplicable "where the plaintiffs allege either that the defendant has made false statements or has distorted the truth by making false but misleading statements." (Pet. A-29). Applying this principle, together with the court of appeals' definition of misrepresentation, results in the *Ute* presumption only being applicable where absolutely no affirmative statements are made.

As established in the Petition, by applying a standard under which the *Ute* presumption is applicable only in the absence of affirmative statements, the court below rendered a decision conflicting with *Affiliated Ute* and decisions of other courts of appeals which apply the *Ute* presumption even where misrepresentations are made. WLJ nevertheless argues that some of the cited cases do not conflict because the decisions state that the *Ute* presumption applies in cases involving primarily omissions. WLJ's argument is unpersuasive, completely ignoring that the cited cases involving both omissions and misrepresentations did not apply the restrictive standard under which the *Ute* presumption is inapplicable if misrepresentations are involved. WLJ completely misreads *Sharp* which expressly held the *Ute* presumption applicable to cases involving *both* misrepresentations and omissions. *Sharp* is squarely in conflict with the decision below. Moreover, WLJ made absolutely no effort to distinguish or explain the other cited courts of appeals' decisions which also squarely conflict with the result here.[8]

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[8] *Barnes v. Resource Royalties*, 795 F.2d 1359, 1367 (8th Cir. 1986) (because omissions were material, *Ute* presumption applies); *Austin v. Loftsgaarden*, 675 F.2d 168, 177 (8th Cir. 1982) (affirmed where dual instruction permitting reliance for omissions was given); *Blackie v. Barrack*, 524 F.2d 891, 905-906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S. Ct. 57 (1976) (*Ute* presumption applies where both misrepresentations and omissions alleged).

4. The Fraud-On-The-Market Theory.

(a) *Newly Issued Securities.* WLJ argues that the decision below imposing an insurmountable burden upon a plaintiff class in an action involving an initial public offering does not conflict with decisions of other courts of appeals. WLJ ignores the cited appellate decisions which did not require proof that the promoters knew the enterprise was patently worthless. WLJ makes no effort to distinguish these cases or to explain how they are consistent with the decision below. WLJ merely argues there is no conflict because those courts have not yet considered the unprecedented burden imposed below. WLJ's argument does not dispose of the fact that a conflict presently exists.

Attempting to justify the decision below, WLJ argues that *Shores* involved a wholly fraudulent bond issue "because there was never any intention or expectation that the issuing enterprise would make a profit and pay any return on the bonds", whereas, in contrast, Westside was a legitimate enterprise. (WLJ, 14-15). WLJ is wrong on both counts. *Shores* did not involve a completely worthless enterprise; indeed, the *Shores* plaintiffs received a return of approximately 1/3 of their investment, only slightly less than the 38% return received by plaintiffs here as of trial. Further, *Shores*, which was on appeal from the granting of summary judgment, did not consider the issue of the promoter's intention. Rather, the Court there merely considered whether plaintiffs could state a claim under 10(b), notwithstanding their failure to read the offering documents. The court then set forth the requisite elements for such a claim, which did not include the requirement that the plaintiff prove the promoter knew the enterprise was patently worthless.

WLJ's characterization of Westside as a legitimate enterprise is equally specious. WLJ distorts the record, arguing that Westside was legitimate because it made full payments to the bondholders. However, the only "full" payments made to the bondholders were paid from the

capitalized bond proceeds – *i.e.*, the bondholders' own money. Payments ceased for 1½ years after exhaustion of the bondholders' funds during which time Fryar pocketed all revenues, including those paid as reimbursement for interest payments to the bondholders. As of trial, only one payment had been made to investors from Westside's revenues and that was at substantially reduced interest rates. Only by severely reducing the future payments to be made to bondholders was Westside able to survive, hardly the track record of a legitimate enterprise. Notably, WLJ totally avoids reference to the siphoning of over $2 million by Fryar and his Bermuda corporation, acts hardly connected with a legitimate enterprise.[9]

WLJ further misreads the decision below, arguing that it merely limits the *Shores* rule "to situations in which the issuer enterprise does not have legitimate worth". (WLJ, 15). The decision below goes much further, however as it expressly limits application of the rule to cases "where the promoters knew the enterprise itself was patently worthless". (Pet., A-35-36). WLJ later concedes the severity of this restriction, acknowledging, in effect, that the decision limits "Rule 10b-5 class actions [to] cases of egregious fraud". (WLJ, 16). The remedial provisions of the securities laws, however, were not intended to reach only cases of "egregious" fraud.

(b) *The "Basic" Fraud-On-The-Market Theory.* In *Basic Inc. v. Levinson*, 485 U.S. 224, 108 S.Ct. 978 (1988), this Court held the fraud-on-the-market theory applicable to transactions occurring on an "impersonal, efficient" market as opposed to face-to-face transactions. Taking a quantum leap in logic, WLJ argues that the Basic fraud-

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[9] Although WLJ argues Westside "quickly filled to capacity" (WLJ, 3), over 20 months expired between physical completion and 80% occupany, one year more than projected. The delay in reaching capacity resulted from a freeze on referrals due to the fraud. (A-106).

on-the-market theory is limited to "purely secondary transactions on a highly organized and extremely efficient national market". (WLJ, 3). This Court did not impose such a limitation and WLJ makes no effort to explain the *Basic* Court's reliance upon decisions involving revenue bonds similar to those at issue here.

WLJ argues that petitioners' only complain of a factual finding. To the contrary, the decision below, as a result of its heavy reliance on *Shores*, seemingly held as a matter of law that revenue bonds do not trade in an impersonal, efficient market.[10]

(c) *The Emasculation of The Class Action Device.* Apparently recognizing that the decision below destroys the effectiveness of the class action device in a § 10(b) claim, WLJ argues that a plaintiff's remedies are not emasculated because claims may be brought under § 12(2) of the Securities Act which does not require proof of reliance. WLJ's argument ignores that statute's inapplicability and severe limitations. Specifically, a § 12(2) action: (1) is inapplicable to most municipal securities transactions; 15 U.S.C. § 77(c); § 77(L); (2) may only be brought against the actual seller or those who solicited the transaction, *Pinter v. Dahl*, ___ U.S. ___, 108 S.Ct. 2063 (1988), parties which in most municipal securities transactions either are shell corporations or are insolvent; (3) has a brief statutory limitation period which severely restricts claims; and (4) provides only the remedy

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[10] *Shores* notes that it did not consider evidence regarding the type of market and did not determine if the plaintiff bought in the primary or secondary market. *Shores v. Sklar*, 647 F.2d 462, 467 (1981), *cert. denied*, 459 U.S. 1102, 103 S. Ct. 722 (1983).

of rescission which may not in all cases sufficiently compensate plaintiffs.[11]

CONCLUSION

The decision below squarely conflicts with decisions of other courts of appeals concerning the duty owed by attorneys and the entitlement of plaintiffs to a presumption of reliance. More importantly, the case presents important issues of federal securities laws which should be resolved by this Court, a fact not countered by WLJ.

Respectfully submitted,

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[11] Here, the court below held the plaintiffs were entitled to damages under a benefit of the bargain measure of damage designed to "compensate them from the loss of a contracted right to a guaranteed stream of income." (Pet., A-75). This remedy is not available under §12(2).